



DEFENSE CONTRACT AUDIT AGENCY

AUDIT REPORT NO. 3311-2002K11010001



May 13, 2004

PREPARED FOR: Corporate Administrative Contracting Officer (CACO)
ATTN: DCMDW-GEOSB (Ms. Catharina N. Ignacio)
Defense Contract Management Agency
Defense Contract Management Agency, San Antonio
4100 Clinton Drive, Mail Drop 01-660
Houston, TX 77020-6237

PREPARED BY: Arlington Branch Office
KBR Suboffice
4100 Clinton Drive, 01-B2P
Houston, TX 77020-6237
Telephone No. (713) 753-2167
FAX No. (713) 753-2919
E-mail Address dcaa-fao3318@dcaa.mil

SUBJECT: Audit Report of Kellogg Brown and Root, Inc.
Billing System Internal Controls

CONTRACTOR: Kellogg Brown and Root, Inc.
ATTN: Government Compliance
4100 Clinton Drive, Mail Drop 01-660
Houston, TX 77020-6237

REPORT RELEASE RESTRICTIONS: See Page 24

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SUBJECT OF AUDIT

By submitting payment requests under government flexibly-priced and fixed-priced contracts, Kellogg Brown and Root Services, Inc. (KBR) asserts that its internal controls are adequate to provide reasonable assurance that:

- Applicable laws and regulations are complied with;
- The accounting system and cost data are reliable;
- Risk of misallocations and mischarges are minimized; and
- Contract allocations and charges are consistent with invoice procedures.

We have examined KBR Houston's billing system as of April 1, 2004, to assure that KBR's system of billing controls is adequate to provide billed costs that are reasonable, compliant with applicable laws and regulations, and subject to applicable financial control systems, and to evaluate KBR's compliance with the system's internal control requirements. Our results of audit only cover the billing system processes in Houston, TX. We have not completed our testing of the accounting system which includes KBR's in-theatre accounting and accounts payables systems. The accounting system information coming from in-country addresses the adequacy of KBR's requisitioning, purchasing, and payment policies and procedures, which directly affect the billing of costs incurred in Kuwait and Iraq.

KBR is responsible for establishing and maintaining an adequate billing system. Our responsibility is to express an opinion on the adequacy of the billing system based on our examination.

EXECUTIVE SUMMARY

In our opinion, the contractor's billing system is inadequate in part. Our examination disclosed several deficiencies in KBR's billing system resulting in billings to the governments that are not prepared in accordance with applicable laws and regulations and contract terms. We also found system deficiencies resulting in material invoicing misstatements that are not prevented, detected and/or corrected in a timely manner. As a result, KBR is not authorized for direct billing and will be required to continue to provide all billings to DCAA for provisional approval prior to submission for payment. We recommend that KBR submit a detailed milestone plan for correcting the deficiencies cited in the report.

SIGNIFICANT ISSUES

1. Our audit has found KBR does not properly brief its contracts and the associated task orders. KBR's Contract Policy & Process, CA-S-03, dated August 29, 2002 states the contractor "shall develop a contract post award summary and the DCAA contract brief" as soon as possible but no later than three business days after contract award. Our audit found that KBR is not following its established procedure.
2. Policies and procedures currently outlined in KBR's November 2002 Handbook, *Guidelines and General Billing Procedures for U.S. Government Contracts* are

inadequate or do not exist to ensure billings on government contracts are in compliance with the Federal Acquisition Regulation. Policies and procedures are inadequate for the processing of offsets and vouchers on inactive and physically completed contracts. We also found policies do not exist for the processing of Time and Material (T&M) billings, and for monitoring the adequacy of the subcontractor's accounting and billing system.

3. KBR is not following its current written billing procedures when processing vouchers. KBR personnel do not complete or only partially complete the Management and Project checklists; do not adjust billing rates to actual rates in a timely fashion; fail to notify the Administrative Contracting Officer (ACO) or paying office of refunds and overpayments; do not properly brief task orders associated with all contracts; and by bill the government unallowable costs.
4. KBR does not have adequate controls over subcontract billings. Our audit activity has identified inadequate or nonexistent policies and procedures for notifying the government of potential significant subcontract problems that impact delivery, quality, and price. KBR also does not monitor the ongoing physical progress of subcontracts or the related costs and billings. This lack of controls resulted in significant issues with the billings processed for KBR's Dining Facility Subcontract (DFAC) costs in Kuwait and Iraq.

SCOPE OF AUDIT

We conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we obtain a sufficient understanding of internal controls to plan financial audits and determine the nature, timing, and extent of tests to be performed. An examination of internal controls includes:

- identifying relevant system control objectives and associated control activities;
- obtaining an understanding of all applicable components of internal control for the identified control objectives and activities;
- determining if the internal controls are adequate and in operation; and
- assessing control risk to use as a basis for planning the nature, timing, and extent of substantive testing in other financial related audits.

We evaluated the billing system using the applicable requirements contained in:

- Federal Acquisition Regulation (FAR);
- Defense FAR Supplement (DFARS); and
- Cost Accounting Standards (CAS).

Our examination specifically tested the billing system's internal control procedures used in Houston, TX associated with the following control objectives:

- Billing System Policies and Procedures;
- Implementation of Policies and Procedures;

- Training of Employees;
- Contract Briefings;
- Management Reviews and Approvals;
- Reconciliation of Recorded and Billed Costs;
- Management of Contract Overpayments, Refunds and Offsets;
- Subcontractor Billing Oversight;
- Exclusion of Non-billable Costs; and
- Adjustment of Cost and Rates.

Test procedures were applied from August 30, 2002 to April 1, 2004. We believe that our examination provides a reasonable basis for our opinion.

RESULTS OF AUDIT

In our opinion, the billing system and related internal control policies and procedures of KBR are inadequate in part. As a result, KBR is not authorized for direct billing and will be required to continue to provide all billings to DCAA for provisional approval prior to submission for payment.

Our examination noted 10 significant deficiencies in the design or operation of the internal control structure. In our judgment, these deficiencies could adversely affect the organization's ability to record, process, summarize, and report billings in a manner that is consistent with applicable government contract laws and regulations. The conditions are detailed in the "Statement of Conditions and Recommendations" below. The cost impact to the government is indeterminable; however, we consider the potential impact to be significant based on the size of KBR's operations. KBR's estimated annual and Department of Defense (DoD) sales for CFY 2003 are \$4.1 billion and \$3.9 billion respectively. The significant increase in sales is principally due to two Department of Defense (DoD) contracts for work in Kuwait and Iraq. As a result, we expect the contractor's billings to the government, especially for DoD to increase significantly in CFY 2004.

As a result of control risk assessments, our audit effort in the following areas will be increased:

- Incurred Indirect/Direct Costs;
- Contract Status Reporting;
- Billings; and
- Contract Close-outs.

We examined only the billing system. Accordingly, we express no opinion on the contractor's internal controls taken as a whole.

On February 12, 2004 we provided a draft copy of the Statement of Conditions and Recommendations and discussed the results of our examination with Todd Bishop, KBR

manager of Government Compliance. KBR provided their written response on March 5, 2004. The contractor partially concurred with condition statements and has completed or outlined corrective action to resolve the conditions. The contractor's complete response is included in the Appendix. The contractor's responses for each condition statement have been incorporated in their entirety in each respective condition statement.

We will conduct a follow-up audit in approximately six months to determine if the contractor's corrective actions have been implemented and the conditions have been corrected.

We wish to express our appreciation to KBR for the cooperation extended to the audit team throughout our review.

STATEMENT OF CONDITIONS AND RECOMMENDATIONS

Our condition statements 1, 2, and 8 identified below were originally reported in our billing system Audit Report No., 3521-2001D11010001, dated August 9, 2002. The remaining conditions were identified as a part of this audit as well as our Audit of Contract Overpayments, 3311-2003K173100001 which has been provided as a draft to KBR for comments and our Subcontract Management Operations Audit, 3311-2004Q10503003 which has also been provided to KBR for comments. We expect to issue these reports in the next 45 days.

1. Lack of Written Billing Policies and Procedures

a. Prior Condition:

KBR does not have formal written policies and procedures in place to assure instructions for both automated and manual tasks are clearly defined, delegated duties and responsibilities are formally documented and communicated to employees, and processes are performed consistently. Without formal written policies and procedures and instruction on their use, the risk of submitting inaccurate billings to the government increases.

b. Status of Corrective Action Taken on Prior Recommendations

As a result of our prior condition KBR issued *Guidelines and General Billing Procedures for U.S. Government Contracts* dated November 1, 2002. We reviewed the procedures issued by KBR to determine if they had corrected the prior condition cited. We found the procedures general in nature with few specifics. KBR representatives explained that more detailed procedures were issued by project.

We reviewed the general procedures in conjunction with KBR's project specific procedures and found the following specific deficiencies:

- (1) The project specific procedures do not address many of the criteria necessary to ensure proper and accurate completion of billings. KBR stated due to the unique

nature of the various contracts, generic billing procedures could not possibly cover the myriad of situations that would need to be addressed and that KBR has project specific billing procedures for the various contracts it performs. We found the project specific billing procedures contained little more than the directions to prepare the paperwork.

- (2) KBR does not have written policies and procedures for processing offsets. KBR stated that it does not process offsets. However, during our review, we noted instances where KBR processed offsets by reducing current requests for payment on contract billings. Examples of offsets processed by KBR include:
 - The Balkan Support Contract, contract number DACA78-99-D-0003, scrap sales proceeds are processed as offsets against current requests for payment.
 - An Army contracting officer advised KBR in July 2003 to offset a \$17,000 overpayment against current request for payment, contract number DABT-63-98-C-0060.
 - The Navy CONCAP contracting officer advised KBR in July 2003 that the preferred method of processing overpayments or over-billed amounts was offsets on subsequent public vouchers or requests for payment, contract number N62470-00-D-0005.
- (3) KBR has not developed formal, written procedures for processing contract cost data after extraction from the KBR Financial application system. Documented formal procedures will ensure compliance with management's intentions and allow for a consistent application on all contract billings. The contractor's general policy identifies steps for preparing the monthly booked costs to billed costs reconciliation; however, the explanation begins with the costs on a spreadsheet with no indication of where or how these costs are accumulated.

Clearly documented policies, procedures, and processes are essential because failure to comply with the FAR and contract requirements can result in harm to both the contractor and the government due to over or under billings on government contracts.

c. Recommendations:

We recommend KBR implement the following corrective actions:

- (1) Review the individual program guidance to ensure it incorporates the elements of the overall company policies to ensure compliance with the FAR and contract provisions.
- (2) Develop adequate policies and procedures for processing offsets on government contracts to ensure contract offsets are processed only after providing notification to the ACO and receiving instruction from the ACO and/or the paying office.

- (3) Expand the General Guidance to include procedures for obtaining and analyzing contract cost data.

d. Contractor's Reaction:

Response dated March 5, 2004

- (1) As noted by DCAA, KBR developed and implemented KBR Government Operations Guidelines and General Billing Procedures for U.S. Government Contracts (Billing procedures) dated November 1, 2002.
- (2) Billing Procedures will be revised to incorporate the statement, "It is not company practice for Government Operations projects to create offset invoices unless directed specifically by the customer, procurement office, etc." Under the Balkan's support contract KBR was directed to record scrap sales as an offset.
- (3) KBR is currently developing additional procedures and information for processing contract cost data after extraction from the KBR Financial Application System through invoice preparation.

e. Auditor's Comments:

We reviewed the Balkans Desktop Manual and Restore Iraqi Oil (RIO) Procedures to determine if the programs' guidance expanded on the KBR guidance. In both cases the guidance was for preparing the actual invoice with no reference to FAR or contract requirements.

Additionally, the contractor's revised general policies address the prior identified conditions; however, we also found the revised general policies do not address the monitoring of subcontractor's accounting and billing systems for adequacy and the preparation of Time and Material billings. Therefore we recommend the following changes to KBR's general policies:

- (1) Develop policies to ensure compliance with FAR 52.216-7, Allowable Costs and Payments. The contractor's policies and procedures should provide for monitoring the subcontractor's accounting and billing systems; obtaining, on a periodic basis, the subcontractor's reconciliation of billed and paid amounts on major subcontracts, require timely notification to the prime contractor of any overpayments and that refunds or offsets be processed within 30 days. Additionally the policies should address the contractor's requirement to immediately notify the subcontractors of any contract administration adjustment impacting the subcontractor's billings and to timely adjust its billings or submit refunds to the government for identified subcontractor overpayments that have been included in billings to the government. The policies and procedures should also address how KBR buyers determine the adequacy of subcontractor billing systems. The end result of not monitoring the subcontractor's accounting and

billing systems are increased costs billed to the government because of duplicate or incorrect subcontractor invoices and noncompliance with FAR 52.216-7.

- (2) Develop written policies for generating T&M invoices in accordance with contract and FAR requirements. KBR's policies do not address the procedures for preparing invoices on T&M contracts. Billings on T&M contracts are unique in that labor and material rates establish what the contractor can bill; additionally FAR 52.232-7, Payments Under Time and Material and Labor Hour contracts require a five percent withhold on labor costs, not to exceed \$50,000 and establishes other billing limitations. The potential exists that over payments could occur if billings are not prepared correctly.

We will conduct a follow-up audit in approximately six months to determine if our recommended additional corrective actions have been implemented and the conditions have been corrected.

2. Failure to Adjust Billings Promptly for Changes in Indirect Rates

a. Prior Condition:

KBR does not adjust its indirect billing rates to year –end actual rates in a timely fashion. Adjusting indirect billing rates in a timely manner ensures at year end, the amount of indirect costs reimbursed is as close to the certified amount as possible. Incurred cost billings are cumulative, and therefore, should reflect the impact of any adjustments as soon as they are known. The contractor should have procedures and controls in place to ensure the prompt adjustment of billings to reflect adjustments in indirect rates.

b. Status of Corrective Action Taken on Prior Recommendations

The contractor's corrective action taken since the initial audit has not adequately addressed the condition reported in the prior audit. In our current audit, we found that KBR is not adjusting billings on all contracts and is not completing the adjustments timely. We reviewed adjustment vouchers on a test basis and documented the following conditions:

- The contractor has not made the required indirect rate billing adjustments on contract number FA2550-96-C-0003 for FY 2000 and 2001 and on contract number DAKF11-99-D-0006, task order LM05 for FY 2001.
- We also found instances where the contractor did not make billing adjustments within the required 45 days after final indirect rates were established as prescribed by its billing procedures.

c. Recommendations:

We recommend KBR implement corrective action to assure proper and timely billing adjustments on all cost-reimbursable contracts. KBR must ensure timely year-end adjustments

are performed on all contracts within 45 days of determining its year-end indirect rates. KBR should notify its billing personnel of any changes to the billing procedures to ensure compliance.

d. Contractor's Reaction:

Response dated March 5, 2004

The two contracts referenced (FA2550-96-C-0003 for FY 2000 and 2001; and DAKF11-99-D-0006, task order LM05 for FY 2001) were adjusted in August of 2002. This adjustment supporting data was provided to DCAA.

KBR has submitted adjusting invoices for the actual final un-audited years (FY2000, FY 2001, and FY 2002) indirect cost rates. FY 1999 is the most current audited and negotiated final indirect cost rate.

In the past KBR Government Compliance has notified the projects of rate updates via e-mail. KBR will formalize this practice, in conjunction with the FY 2003 incurred cost submission preparation, as part of its billing procedure manual.

e. Auditor's Comments:

The revised contractor's General Guidance directs Government Compliance to update and distribute to the program offices, a rate matrix within 15 days of (i) submission of final indirect cost rate proposal for the calendar year; (ii) any update to the FPRA; negotiation/settlement of final rate agreement or (iii) when other adjustments are determined. However, the guidance should direct timely submission of vouchers, within 30 days, to adjust for over or under billings of indirect rates.

To test KBR's assertions made in its response, we tested the timeliness and accuracy of the rate adjustments for five task orders on contract DACA78-99-D-0003. Provisional billing rates were issued on December 5, 2003 and the contractor submitted adjustment vouchers on December 29, 2003.

3. Incorrectly Prepared Adjustment Vouchers

a. Condition:

Our audit determined prior to 2003, KBR incorrectly prepared its year-end billing adjustment vouchers. We examined adjustment vouchers on a test basis to determine if the vouchers were properly prepared, mathematically correct, and reconcilable to KBR's accounting records. While performing our evaluation, we found KBR uses its project year-to-date billed amount to calculate its adjustment voucher amount instead of booked or claimed costs. KBR now has a process to reconcile these differences on every voucher submitted.

However, KBR's system currently does not segregate cost by year so that rate adjustments and reconciliations can be easily made and the rates used can be identified.

b. Recommendation:

We recommend KBR ensure its procedures and controls to prepare year-end adjustment vouchers and booked-to-billed reconciliations are always followed. The process should provide for segregation of cost by year so rate adjustment can be easily made and the rates used can be identified and reconciled.

c. Contractor's Reaction:

Response dated March 5, 2004:

KBR will formalize the DCAA's recommendation, in conjunction with the FY 2003 incurred cost submission preparation, as part of its billing procedure manual.

Rates for the year 1999 are the most current audited and negotiated final indirect cost rates. KBR has submitted adjusting invoices for the actual final un-audited years (FY 2000, FY 2001 and 2002) indirect cost rates.

d. Auditor's Comments:

KBR's comments are responsive to our recommendations. After receiving KBR's comments, we reviewed the rate adjustments made for revised provisional billing rates on 5 task orders for contract DACA78-99-D-0003 and determined that costs and rate applications were segregated by year.

4. Lack of Appropriate Reviews and Approvals of Vouchers

a. Condition:

Our audit found KBR failed to follow its billing procedures requiring appropriate management review and approval of vouchers prior to submission to the government for payment. *KBR Government Operations Guidelines and General Billing Procedures for U. S. Government Contracts* (billing procedures) states "The project business manager (sometimes called project accountant), or designee, must complete and sign the checklist entitled "*Project Checklist for Reviewing Invoices before Submittal*." The billing procedures also states "The project manager, or designee, must complete and sign the "*Checklist for Management Review of Invoice*" before the invoice can be submitted for payment."

We examined 14 interim vouchers prepared between April and August 2003 and found KBR had not completed the management checklist on 9 of the 14 interim vouchers. We also found KBR had had not completed either the project checklist or the management checklist for 2 of 14 interim vouchers. These deficiencies impact 3 major contracts, DACA78-99-D-0003, DABT23-01-C-0008 and DAKF11-99-D-0006.

We believe cost-reimbursement contracts represent an increased risk to the government when the contractor's billing system does not protect against or detect billing errors. It is vital that the contractor has controls in place to minimize the risk of over billing the government.

b. Recommendation:

We recommend KBR follow its current billing procedures and prepare the appropriate checklists to ensure properly documented billings. KBR procedures specifically state that the project business manager should complete both the project checklist and management checklist when processing vouchers.

c. Contractor's Reaction:

Response dated March 5, 2004

KBR has implemented corrective action and is monitoring the completion of the checklists in accordance with KBR procedures.

d. Auditor's Comments:

The contractor has proposed adequate corrective action. As a follow-up, we reviewed recently submitted vouchers for the Balkans program and vouchers being submitted for the RIO program and in both instances the project checklist and management checklist were completed.

5. Failure to Notify ACO of Contract Over Payments

a. Condition:

Our current audit found KBR is not notifying the ACO or the paying offices prior to submission vouchers to correct contract overpayments. KBR's government billing procedures require contacting clients and/or the paying office to resolve issues regarding past-due invoices and any overpayments or underpayments within 30 days of identification of the issue and/or follow up as necessary until final resolution. Recently the FAR was amended to require the contractor to notify the contracting officer if the contractor becomes aware of an overpayment on a contract invoice (see FAC 2001-02).

KBR must comply with its policies and procedures and FAR for notifying contracting officers and paying offices for instruction to resolve issues regarding past-due invoices and overpayments or underpayments within 30 days of identification of the issue and follow up as necessary until final resolution. All significant overpayments/duplicate payments or over-billed amounts returned to the paying offices as refunds must be accompanied with checks for the amount of the credit voucher.

We found the following overpayments were not resolved in a timely manner or in accordance with FAR and KBR policies:

- A \$382,000 credit public voucher for contract number N62470-00-D-0005, delivery order 003, invoice number 0208-304-UR651, dated August 27, 2002, was sent to the Navy CONCAP payment office without prior notification to the ACO or paying office. KBR refunded the Navy contract overpayment for \$382,000 on June 10, 2003, which was 490 days after the overpayment was made.
- A \$17,000 credit public voucher for contract number DABT-63-98-C-0060, voucher number 03034, was sent to the Army contract paying office without prior notification to the ACO or paying office; and KBR did not include the check due the government with the voucher.
- During 2001, KBR identified and reported to the General Accounting Office three overpayments totaling \$53,000 relating to contract numbers DAKF11-99-D0066 and FA2550-96-C-0003, but it did not refund the overpayments in a timely manner. The \$53,000 overpayment was not resolved until September 2003 or about 845 days after KBR received the overpayment.
- In September 2002, KBR identified a duplicate payment of \$107,000 for Army Corps of Engineers contract number DACA31-97-D-7000. KBR has yet to provide adequate documentation to show this overpayment has been resolved.

b. Recommendation:

We recommend KBR comply with its current policies and procedures for resolving overpayments. Notification to the ACO must be made immediately and the refund of the overpayments must be made in a timely manner. KBR procedures require notification and resolution within 30 days of identifying an overpayment.

c. Contractor's Reaction:

Response dated March 5, 2004

The duplicate payment of \$107,000 for contract number DACA31-97-D-700 was resolved with the client's directive in September 22, 2003 and the information was provided to the DCAA October 29, 2003.

KBR has implemented corrective action to comply with its procedures and is currently contacting the client and the paying office by correspondence within the 30 days after identifying an overpayment. After notification the resolution may extend beyond the 30 days; however, KBR will continue to work towards final resolution.

d. Auditor's Comments:

The contractor has proposed corrective action to comply with its own procedures. The documentation provided by KBR for \$107,000 dollar overpayment was not considered adequate; therefore, until KBR provides adequate support, the overpayment is still considered outstanding. We are working to resolve this issue. We will address this issue in our follow-up audit scheduled to be completed in approximately six months.

6. Lack of Reconciliation of Recorded to Billed Costs

a. Condition:

We found KBR does not periodically reconcile differences between recorded costs and billed costs on physically complete, but not yet closed contracts. The reconciliation is important to identify physically complete contracts which may be over billed. Our review disclosed that the Launch Operations Support Contract (LOSC) cost reimbursable contract number F08650-95-C-6038, which was physically completed in December 1998, is over billed by approximately \$150,000

b. Recommendations:

We recommend KBR establish procedures and internal controls to ensure reconciliations of billed and recorded costs are performed on a periodic basis for all contracts, including physically completed contracts awaiting closeout. Also, KBR should ensure that final vouchers for physically completed contracts are submitted within 120 days after the settlement of the applicable final indirect rates. If billed costs exceed recorded costs, revised billings and refunds should be submitted within 30 days.

c. Contractor's Reaction:

Response dated March 5, 2004

KBR will formalize the DCAA's recommendation, in conjunction with the FY 2003 incurred cost submission preparation, as part of its billing procedure manual.

Rates for the year 1999 are the most current audited and negotiated final indirect cost rates. KBR has submitted adjusting invoices for the actual final un-audited years (FY 2000, FY 2001 and 2002) indirect cost rates.

d. Auditor's Comments:

KBR has proposed adequate corrective action. We will verify the corrective action in our follow-up audit scheduled in about six months.

7. Lack of Adequate Contract Briefings

a. Condition:

Our audit has found KBR does not properly brief its contracts and the associated task orders to identify terms impacting billings. KBR's Contract Policy & Process, CA-S-03, dated August 29, 2002 states the contractor "shall develop a contract post award summary and the DCAA contract brief" as soon as possible but no later than three business days after contract award. The policy continues on to state, KBR "shall update the DCAA Contract Brief or KBRSI Contract Billing Summary as needed (i.e., upon receipt of the contract modification but, no less than on an annual basis)."

During our audit we identified two contracts, N62470-00-D-0005 and DAAA09-02-D-0007 did not have a contract brief on each of the associated task orders. KBR prepares a contract summary which summarized the contract and the task orders. The contract summary included information such as performance period, brief description, and the cost of the contract or task order as modified. The contract summary does not identify special requirements, funding, and limitations nor does it identify the contract clauses relative to the specific task orders.

Inadequately briefed contracts result in incorrect billing to the government due to noncompliance with unique contract clauses requirements (i.e. period of performance, level of effort, unallowable costs, specials billing requirements, funding limitations, etc.).

b. Recommendation:

We recommend KBR brief each contract and task order as prescribed by its policies and procedures. We further recommend KBR include any special requirements or special limitations in each of the contract briefs.

c. Contractor's Reaction:

Response dated March 5, 2004

KBR will to the maximum extent practicable ensure that contract briefs include billing details, contract types and other pertinent data important for the billing process.

d. Auditor's Comments:

KBR has not proposed adequate corrective action. In March 2004, to further test KBR's actions we requested copies of contract briefs for three programs from the accountants responsible for submitting vouchers for those programs. The accountants for the RIO program did not have a copy of the contract brief; but indicated KBR's Government Compliance department could provide it. (Mr. Floyd Green, Government Compliance did provide a copy of only the basic contract brief). The Balkans accountants did not have copies of their contract briefs either, and indicated that Contract Administration would have a copy. The accountant for

the LOGCAP presented only a copy of the prime contract, and a summary of funding levels for the individual task orders.

The contract brief is a tool to ensure that government invoices are prepared in accordance with contract terms and conditions. KBR should ensure that the individuals responsible for preparing the billings have direct access to the contract briefs and review them for changes prior to preparing each billing. We recommend KBR take meaningful corrective action to ensure complete contract briefs are prepared and are available to those preparing contract billings.

8. Billing of Unallowable Costs

a. Prior Condition:

Our prior audit found KBR billed unallowable costs on Contract No. F04701-90-C-0080. FAR 31.201-6, Accounting for Unallowable Costs requires that costs that are expressly unallowable or mutually agreed to be unallowable, be identified and excluded from any billing, claim or proposal applicable to a Government contract.

KBR's final invoice included approximately \$45,000 in costs which included overhead and G&A that had been determined to be unallowable by DCAA in Audit Report No. 3521-95D10160003, dated September 30, 1997, and agreed-to by the contractor. The contractor reduced interim vouchers for the questioned costs, but KBR did not reclassify the questioned costs to an unallowable account in its ledger. KBR prepared the final voucher from its accounting records which did not reflect the unallowable costs, resulting in billing the unallowable costs in its final voucher.

We believe the lack of written general billing procedures prescribing actions to take regarding costs determined to be unallowable under these or similar circumstances has contributed to this condition; which resulted in an over billing to the government.

b. Status of Corrective Action Taken on Prior Recommendations

The contractor developed and implemented KBR Government Operations Guidelines and General Billing Procedures for U. S. Government Contracts (billing procedures) dated November 1, 2002. We believe the billing procedures addressed the unallowable/unallocable costs criteria necessary for the billing system.

c. Contractor's Reaction

KBR concurs with the DCAA's position.

9. Inadequate Controls over Subcontract Billings

a. Condition

Our audit found KBR has inadequate controls over subcontract billings. We found KBR has no documented mechanism for subcontract administrators to monitor subcontract billings to ensure they comply with subcontract terms. KBR requires its subcontract administrators to prepare documents that state whether a subcontractor has delivered its goods or services in accordance with the subcontract terms. However, we found no such documents included in KBR's subcontract files, nor did we find any log of subcontractor payments.

The need to monitor subcontractor performance as part of the subcontract management function is well established. The Contractor Purchasing System Review (CPSR) guidebook Appendix B – Typical Content of Contractor Policies, Procedures and Forms states in summary that typical contractor policy and procedures include statements covering the following: “...(5) Subcontract award and administration...(iv) maintaining visibility of subcontracts in the areas of cost, schedule, and performance, (v) monitoring progress payments to subcontractors.

The advantages gained by prudent and capable efforts in planning and negotiating subcontracts can be dissipated through the failure of upper-tier contractors to administer their subcontracts properly. KBR's subcontractor invoicing and payments must be monitored for compliance with FAR 52.216-7, *Allowable Cost and Payment*. This clause requires higher-tier Subcontract Administrators to determine and/or approve subcontractor progress made; costs incurred, and ensure timely delivery of an acceptable product.

Policies and procedures should be in place to notify the government of potential significant subcontract problems that may impact delivery, quality, or price. The prime contractor's procedures related to cost controls should be directed to production and financial controls, with emphasis on those controls which ensure physical progress of production are commensurate with reimbursement.

KBR does not have a mechanism in place at the subcontract level to monitor the on-going physical progress of a subcontract or the related costs and billings. Procurement files do not contain a subcontract invoice/payment log for tracking the number of invoices received, the cumulative amount incurred and billed, or the available funding. The subcontract personnel on-site are required to verify subcontracts were being completed in accordance with the subcontract terms and that a vendor should be paid.

An example of a problem that can be caused by this condition is KBR's payment of DFAC subcontractor invoices that are not reasonable in amount and are not computed in accordance with subcontract terms and conditions. The subcontract required the subcontractor to create a billing format to include “meals served for each billing item.” The subcontract indicates meals served will be the basis of the billed amounts as follows:

“SUBCONTRACTOR will create a Subcontract billing format acceptable to CONTRACTOR, to be used for all payments. This form will include, but not be limited to the full name and address of the Subcontractor work performed, and meals served for each billing item; the previous billed amount; the ‘to date’ billed amount; the billing period, and the SUBCONTRACT number.”

Only the on-site subcontract administrator is actually in a position to verify the billing format met the intended subcontract objectives and was acceptable to measure the performance occurring in the field. However, the billing format was not addressed until recently. One result of this lack of monitoring is the billing methodology did not consider actual meals served in determining the billing amount, despite the expressed terms of the subcontract.

The condition identified in the Operations Subcontract Management Audit contributed to the following irregularities with the billings process for DFAC costs in Kuwait and Iraq identified by the DCAA Iraqi Branch Office:

- (1) Inadequate internal controls over payments to subcontractors;
- (2) Payments to subcontractors that are unreasonable and not computed per contract terms;
- (3) Missing published standard operating procedures for food service personnel
- (4) Inadequate monitoring for compliance with prime contract and master agreement terms and conditions; and
- (5) Improper segregation of duties for DFAC subcontract negotiator/approving officer.

The lack of controls has a potential of resulting in over billings to the government.

b. Recommendation

We recommend KBR prepare policies and procedures to document processes for ensuring subcontractor performance is monitored by all of its subcontract administration personnel. KBR should establish a process/mechanism for the subcontract administrators to have visibility into subcontract payments as well as monitor subcontract performance to specific subcontract terms.

KBR’s subcontract/vendor payment procedures should include, but not be limited to, the following:

- Procedures for payments based on receipt of goods and/or services for a fixed price.
- Procedures for payments based on the percentage of work accomplished and dollars expended on a fixed price purchase order.
- Procedures for periodic payments for costs incurred and a percentage of fees earned monthly under a cost reimbursable contracts.
- Procedures for milestone payments based on measurable work progress on a fixed price purchase order. For example, work accomplished that can be

measured, such as meals served, camp operations running by a certain date, or services delivered.

- Appropriate invoice approval and payment forms and/or worksheets such as:
 - Invoice Approval for Cost Reimbursable Subcontracts
 - Invoice Approval for Milestone Payments
 - Invoice Payment Request
 - Invoice Approval for Progress Payments
- Procedures for tracking subcontractor invoice submissions, payments, and available funding along with the requirement for subcontract administrators to maintain a subcontract invoice log in the procurement file documentation.

c. Contractor's Response:

KBR's response, dated March 5, 2004

KBR's position is that the issues cited by DCAA in support of this Statement of Condition have been misquoted as well as misinterpreted. The end result is that a difference of opinion between DCAA and KBR regarding certain DFAC subcontract terms is now mischaracterized herein as a billing system control deficiency.

DCAA is aware that KBR established a Tiger Team that is actively researching and analyzing the facts and circumstances surrounding each of its DFAC subcontracts. This effort includes a thorough review and analysis of past subcontract payment practices, as well as, developing standardized subcontract practices for future DFAC subcontracts.

Thus KBR believes any conclusion at this time regarding KBR's billing procedures related to the payment of DFAC subcontracts is not only unsubstantiated but also premature.

d. Auditor's Comments:

KBR's response has not addressed the condition. KBR disagrees with our interpretation of the specific DFAC terms; however, adequate controls and management of the subcontract billing process would have allowed the issues currently under review to be addressed sooner. We recommend KBR address the systemic issues in the subcontract billing process. KBR has not yet responded to the Statement of Conditions and Recommendations from the DCAA Subcontract Management Operations audit.

10. Management Oversight – Internal Audit

a. Condition:

We have been unable to determine the adequacy of KBR's internal audit function to ensure compliance with established policies and procedures. A strong internal audit function is required in order to conclude that established internal controls can be relied upon to prevent or detect errors and misstatements in the processing of accounting transactions. We have requested

evidence that KBR's internal audit department is functionally and organizationally independent and sufficiently removed from management to ensure that it can conduct audits objectively and can report its findings, opinions, and conclusions without fear of reprisal. Such evidence includes organization reports, evidence that there is broad audit coverage, that audit recommendations are considered and addressed by management, that the internal audit department has regular communications with the Board of Directors or Audit Committee, and that the internal audit department participates in the development, modification and implementation of significant accounting system changes. It has been KBR's long established practice to restrict DCAA's access to the internal audit function. As a result – we can place no reliance on management's oversight to ensure that established policies and procedures and other related internal controls are routinely complied with.

b. Recommendation:

We recommend that KBR provide requested access to internal audit functions required to determine the adequacy of its oversight function in ensuring that established internal controls are adequate and complied with.

c. Contractor's Reaction:

The contractor's response is taken from a letter issued to our office on November 24, 2003 which stated KBR's position regarding all internal audits.

All internal audits are conducted by the Halliburton Company on behalf of the Halliburton Board of Directors Audit Committee, not KBR. The Audit Committee is independent of KBR and HES. Additionally, Halliburton Company has no legal or contractual obligation to share these reports with KBR or HES. The information contained in those reports and any actions that may result from the reports belong to the audit committee and are subject to the disclosure requirements and restrictions of Sarbanes Oxley and other laws and regulations applicable to publicly traded companies.

d. Auditor's Comments:

We will continue to pursue internal audit reports at KBR. We believe an adequate internal audit function is integral to a companies internal control structure. Without access to determine if this function operates effectively we are required to assume maximum risk on each audit test we perform.

CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

Kellogg Brown & Root (KBR), also known as the Engineering and Construction Group (E&C), is one of the two operating subsidiary groups of Halliburton. The other operating subsidiary group is Halliburton's Energy Services, Inc. (HESI), also called the Energy Services Group (ESG). The legal structure of Halliburton is different from its operational structure. Halliburton owns all the stock HESI which owns all the stock of DII Industries, LLC (DII). DII in turn owns all the stock of numerous Halliburton legal entities including KBR. Halliburton's two operating subsidiary groups are organized around the products and services provided to the customers they serve.

- The ESG provides a broad array of products and services to upstream oil and gas customers worldwide, ranging from the manufacturing of drill bits and other down hole and completion tools and pressure pumping services to subsea engineering.
- KBR E&C deals with large-scale construction projects including construction and designing of oil and gas processing and refining plants, production facilities, and onshore and offshore pipelines. KBR's non-energy business meets the engineering and construction needs of governments and civil infrastructure customers. Operationally, KBR consists of five business lines – Offshore, Onshore, Operations & Maintenance, Infrastructure, and Government Operations. Government Operations consists of KBR Services, Inc. (KBR SI) and KBR Commercial entities that perform contracts for foreign countries. (KBR SI) is a new subsidiary formed in CFY 2002 as a result of KBR's reorganization due to its planned bankruptcy for asbestos litigation (see the Other Matters Reported Appendix). Most government contracts, signed under several legal entities, have been novated to KBR SI.

KBR SI consists of two operating business units that perform government contracts: Brown & Root Service Operations (BR SO) and KBR Civil Infrastructure (KBR CI).

- BR SO is the primary government segment that provides engineering, construction, operation, and maintenance services for the Air Force, Army, Navy, and NASA. It also provides logistical support services for the U.S. troops in foreign countries through contracts with the Army Corps of Engineers and Army Material Command. BR SO also operates as Management Logistics, Inc. (MLI) to perform projects with a union-represented work force.
- KBR CI, formerly Brown & Root Civil Engineering prior to 2002, provides consulting and civil engineering services primarily for commercial projects. Projects include highways, bridges, stadiums, aviation and water and wastewater infrastructure, facilities modification, and on-call construction.

KBR revenues were approximately \$5.736 billion (B) in contractor fiscal year (CFY) 2002 and \$5.235B in CFY 2001, or about 46 percent of Halliburton Company's total revenue of \$12.572B for CFY 2002 and about 40 percent of \$13.046B for CFY 2001. KBR's operating loss

for CFY 2002 was \$685 million (M) and income for CFY 2001 was \$111M. Halliburton's total operating loss for CFY 2002 was \$112M and operating income for CFY 2001 was \$1.084B.

BRSO's CFY 2002 costs incurred were approximately \$573M and for CFY 2001 costs incurred were approximately \$563M. For CFY 2003, estimated costs were \$4.2 billion. In CFY 2001, BRSO had 95 percent federal-government participation, of which 63 percent was cost reimbursable, 30 percent fixed-price work, and 2 percent time and material. KBRCI reported CFY 2001 revenues of \$95M with about 18 percent federal-government participation. Government participation was 10, 5, and 3 percent for cost reimbursable, time and material, and fixed-price contracts, respectively. The remaining 82 percent of KBRCI's costs was incurred on commercial contracts.

In CFY 2002, corporate home office expenses such as executive management, accounting, communications, human resources, information technology, legal, risk management, and taxes were allocated to operating segments using the three-factor formula. Effective January 2003, a majority of corporate expenses were specifically identified either to KBR or ESG. The only expenses currently allocated using the three-factor formula from the Corporate home office are HALCO 21 costs relating to SAP software implementation and state and franchise taxes. Specific Corporate costs now identified to KBR are charged into the Intermediate Management III (IM-III) Home Office. IM-III provides management support, accounting, and business acquisition functions for all of KBR's business units. The residual expenses in CFY 2003 for these services are allocated to the following business units using the three-factor formula: BRSO, KBRCI, Government Operations United Kingdom (UK) and Asia Pacific (AP), Commercial Infrastructure UK and AP, and KBR Other Commercial.

Government OPS Intermediate Management II (IM-II) Home Office provides global business unit management and accounting and sales and marketing functions. Residual expenses are allocated to BRSO and Government Operations UK and AP using the three-factor formula.

Government OPS Americas BRS Intermediate Management I (BRS IM-I) Home Office provides various functions including accounting, human resources, information technology, sales and marketing, government compliance, quality, and contract administration. The costs associated with these functions are allocated to only BRSO except for government compliance which is also allocated to KBRCI using the three-factor formula.

Infrastructure Intermediate Management II Home Office provides business unit management and accounting and finance to the Infrastructure business unit. Residual expenses are allocated to KBRCI and Commercial Infrastructure UK and AP.

The Americas Infrastructure Intermediate Management I Home Office provides business unit management, accounting and finance, and chief engineer functions to the America Infrastructure activities. Residual expenses are allocated only to KBRCI.

2. Systems

Billing System

Kellogg, Brown and Root Services Inc. (KBR) project controls prepares its invoices and voucher using its Guidelines and General Billing Procedures for U. S. Government Contracts dated October 2002. Project controls is responsible for compiling billings; accordingly, each project is governed by its own project-specific policies and procedures. Accounting is responsible for establishing the requirements for billings in the start-up phase of a project and ensuring the necessary client codes and bill-types are established in the accounting system.

KBR uses an information technology system to process government invoices. KBR employees convert and record contract costs such as labor, subcontracted services and purchases materials through various input systems. All contract costs recorded in the input systems ultimately flow to and are recorded into a KBR financial accounting system called the New Business System (NBS). The NBS is an IBM mainframe legacy system placed into production in 1983. NBS produces financial reports including a job ledger report and maintains accounts payable and accounts receivables sub ledgers. NBS is the book or original records for the corporation. Since 1983 various input and output systems have been added to enhance user interface to NBS. One such system was placed into production within the last two years is called the KBR Financial Application System. The NBS feeds the KBR Financial Application System with a daily file of contract costs.

The KBR Financial Application System is a read-only system for job ledger costs and the system allows accounting personnel to extract job ledger data for invoicing. Accounting personnel extract job ledger data into MS Excel spreadsheets as part of the invoicing process. Accounting personnel summarize job ledger data by job/work order, reconcile amounts to NBS reports, and remove un-billable amounts.

The accounting function determines whether the cost is billable or not during the processing phase of the cost. The bill-type field in the accounting system identifies whether or not a cost can be billed. . The costs are formatted and summarized to meet government billing standards. During the performance of the contract, project billing personnel are responsible for preparing payment vouchers and reconciling the booked costs to the billed costs on a monthly basis, with project accounting also independently performing monthly reconciliations

DCAA PERSONNEL

Primary contacts regarding this audit:

John L. Short, Auditor	<u>Telephone No.</u> (713) 753-2479
Michelle D. Paul, Auditor	(713) 753-2187
Rosemary E. Herrell, Auditor	(520) 794-5032
Darlene G. Brown, Supervisory Auditor	(713) 753-2142
Gordon A. Eeten, Supervisory Auditor	(602) 438-1854 x226

Other contacts regarding this audit report:

William F. Daneke, Branch Manager	(817) 640-4948
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DCAA Arlington Branch Office

FAX No.
(817) 663-4280

E-mail Address
dcaa-fao3318@dcaa.mil

General information on audit matters is available at <http://www.dcaa.mil>.

AUDIT REPORT AUTHORIZED BY:

/signed/
William F. Daneke
Branch Manager
DCAA Arlington Branch Office

AUDIT REPORT DISTRIBUTION AND RESTRICTIONS

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	<u>E-mail Address</u>
Corporate Administrative Contracting Officer ATTN: DCMDW-GEOSB (Ms. Catharina N. Ignacio) Defense Contract Management Agency Defense Contract Management Agency San Antonio Defence Contract Audit Agency NASA Programs 4100 Clinton Drive, Mail Drop 01-660 Houston, TX 77020-6237	Catharina.Ignacio@dcaa.mil
Procuring Contracting Officer Department of the Army Headquarters, U.S. Army Field Support Command Contracting Support Division 1 Rock Island Arsenal	munsonj@osc.army.mil valiant.duhart@us.army.mil watkinsm@osc.army.mil kaddatzj@osc.army.mil Strohmg@osc.army.mil
Procuring Contracting Officer ATTN: CETAC-PD-CT-L, P.O. Box 22250 Balkans Support Contract U.S. Army Corps of Engineers, Transatlantic Programs Center 201 Prince Frederick Dr. Winchester, VA 22604-1405	a.brian.brobson@tac01.usace.army.mil
Department of the Army Headquarters, U.S. Army Field Support Command DCAA Financial Liaison Advisor ATTN: AMSJM-CCS-F/DCAA FLA (John Wessels) Building 104, 1st Floor 1 Rock Island Arsenal Rock Island, Illinois 61299-6500	DCAA-FLA-RIA-1@dcaa.mil
Defense Contract Audit Agency Northeastern Region Iraq Branch Office Camp Arifjan, Kuwait APO AE 09366	Dan.altemus@dcaa.mil
Contracting Officer ATTN: CESWF-CT-C Restoration of Iraqi Oil Contract US Army Corps of Engineer	John.h.rodgers@swf.usace.army.mil

Audit Report No. 3311-2002K11010001

Fort Worth District
Fort Worth, Texas 76102

DCAA European Branch Office
CMR 443, Box 1500
APO AE 09096-1500

dcaa-fao2191@dcaa.mil

Kellogg Brown and Root Services
ATTN: Government Compliance
4100 Clinton Drive, Mail Drop 01-660
Houston, TX 77020-6237
(Copy furnished through CACO)

RESTRICTIONS

1. Information contained in this audit report may be proprietary. It is not practical to identify during the conduct of the audit those elements of the data which are proprietary. Make proprietary determinations in the event of an external request for access. Consider the restrictions of 18 U.S.C. 1905 before releasing this information to the public.
2. Under the provisions of Title 32, Code of Federal Regulations, Part 290.7(b), DCAA will refer any Freedom of Information Act requests for audit reports received to the cognizant contracting agency for determination as to releasability and a direct response to the requestor.
3. Do not use the information contained in this audit report for purposes other than action on the subject of this audit without first discussing its applicability with the auditor.

CONTRACTOR'S RESPONSE



Government Operations, 155 0 Wilson Boulevard, Suite 700, Arlington, Virginia 22209 (703) 526-7500
Fax (703) 526-7585

March 5, 2004

William F. Daneke Branch Manager Defense Contract Audit Agency Arlington Branch Office Arlington,
TX 76006-6223

Dear Mr. Daneke:

The purpose of this letter is to respond to your draft audit report conditions and recommendations regarding the audit KBR's Billing System under Audit Report No. 33112002K11010001. Based on the comments contained in the report, KBR's responses are provided in Attachment A to this letter.

KBR appreciates the opportunity to respond to the various DCAA issues identified within this Statement of Condition. For ease of reference, excerpts from the Statement of Condition are presented in italics, followed by the KBR response in normal text.

If you have any question, please feel free to contact me at 713.753. 4931 or Todd W. Bishop at 713.753.4186, or by e-mail to bill.walter@halliburton.com or todd.bishop@halliburton.com.

Sincerely,

A handwritten signature in black ink, appearing to read 'W. F. Daneke', is written over a faint, larger signature that appears to read 'W. F. Daneke'.

Director, Government Compliance

cc: Mr. Gary Catt, Supervisory Auditor, DCAA Mr. John Short, Supervisory Auditor, DCAA Ms. Catharina Ignacio, CACO, DCMA Mr. Al Neffgen, Chief Operating Officer, KBRSI Mr. Craig Peterson, Vice -President, KBRSI Mr. Pete Glynn, Director, Accounting & Finance

NOTE: This KBR Response to DCAA Audit Assignment No. 3311 -2002K11010001 contains proprietary and confidential information which is authorized to be withheld from the public . Disclosure would cause a foreseeable harm to an interest protected by one or more Exemptions of the Freedom of Information Act, 5 USC Section 552. Furthermore, it is requested that any Government entity receiving this information act in accordance with DoD 5400.7-R, and consider this information as being for official use only (FOUO), and mark, handle

and secure this information so as to prevent unauthorized access.

1. DCAA-Lack of Written Billing Procedures

a. DCAA Condition

1.1 KBR does not have written general policies and procedures covering the billing system. The contractor representatives assert due to the unique nature of the various contracts, generic billing procedures could not possibly cover the myriad of situations that would need to be addressed. However, KBR has project specific billing procedures for the various contracts it performs. Our review of ten of the project specific procedures indicated they do not address many of the criteria for adequate policies and procedures. This is a prior condition. We provided a complete description of this condition in Audit Report Number 3521 -2001D11010001. The contractor developed and implemented KBR Government Operations Guidelines and General Billing Procedures for U.

S. Government Contracts (billing procedures) dated November 1, 2002.

1.2 KBR does not have written policies and procedures for processing offsets. KBR stated that it does not process offsets. However, during our review, we noted instances where KBR processed offsets by reducing current requests for payment on contract billings. Examples of offsets processed by KBR include:

- The Balkan Support Contract, contract number DACA78-99-D-0003, scrap sales proceeds are processed as offsets against current requests for payment;*
- An Army contracting officer, contract number DABT-63-98-C-0060, advised KBR in July 2003 to offset a \$17 thousand overpayment, as described in note 4 above, against current request for payment; and*
- The Navy CONCAP contracting office, contract number N62470-00-D-0005, also advised KBR in July 2003 that the preferred method of processing overpayments or over-billed amounts was offsets on subsequent public vouchers or requests for payment.*

1.3 KBR has not developed formal, written procedures for processing contract cost data after extraction from the KBR Financial application system through invoice preparation. Written approved procedures will ensure compliance with management's assertions and allow for a consistent application for all contract billings.

b. DCAA Recommendations

KBR should establish and maintain procedures for (1) processing offsets and (2) processing contract cost data after extraction from the KBR Financial application system through invoice preparation.

KBR Response to Condition 1:

1. 1.1 As noted by DCAA, KBR developed and implemented KBR Government Operations Guidelines and General Billing Procedures for U. S. Government Contracts (billing procedures) dated November 1, 2002. This procedural Manual was developed in coordination with DCAA.

2. 1.2 Billing Procedures will be revised to incorporate the statement, "It is not company practice for Government Operations projects to create offset invoices unless directed specifically by the customer, procurement office, etc." Under the Balkan's support contract KBR was directed to record scrap sales as an offset.

3. 1.3 KBR is currently developing additional procedures and information for processing contract cost data after extraction from the KBR Financial application system through invoice preparation.

2. DCAA-Failure to Adjust Billings Promptly

a. DCAA Prior Condition

KBR does not require its project managers to submit adjustment vouchers for any over or under billings of indirect rates and direct costs. We provided a complete description of this condition in Audit Report Number 3521 -2001D11010001.

b. DCAA Status of Corrective Action Taken on Prior Recommendation

The contractor's corrective action taken since the initial audit did not adequately address the condition reported in the prior audit. In performing our follow-up review, we found that KBR is not adjusting billings on all contracts. We reviewed adjustment vouchers on a test basis and documented the following conditions:

☐ *The contractor has not made the required billing adjustments on contract number FA2550-96-C-0003 for FY 2000 and 2001 and on contract number DAKF11-99-D-0006, task order LM05 for FY 2001.*

☐ *We also noted instances where the contractor did not make billing adjustments within the 45 days after final indirect rates were established as prescribed by its billing procedures.*

c. DCAA Recommendations

KBR should implement corrective action for the billing adjustments on all cost-reimbursable contracts for prior years so that the amounts of indirect costs reimbursed are as close to the certified amounts as possible;

KBR must ensure timely year-end adjustments are performed on all contracts within 45 days of determining its year-end indirect rates;

KBR should notify its billing personnel of any changes to the billing procedures to ensure compliance; and

KBR Government Compliance, who are responsible for the preparation of the incurred cost submission, should develop a procedure to communicate to the project managers the claimed costs for those projects to facilitate the adjustment process. This could be done at the same time as when KBR Government Compliance distributes the rate matrix.

KBR Response to Condition 2:

The two contracts referenced (FA2550-96-C-0003 for FY 2000 and 2001 and DAKF11-99-D -0006, task order LM05 for FY 2001) both were adjusted in August of 2002. This adjustment supporting data was provided to DCAA.

KBR has submitted adjusting invoices for the actual final un-audited years (FY 2000, FY 2001, & FY 2002) indirect cost rates. FY 1999 is the most current audited and negotiated final indirect cost rate.

In the past KBR Government Compliance has notified the projects of rate updates via e-mail. KBR will formalize this practice , in conjunction with the FY 2003 incurred cost submission preparation, as part of its billing procedure manual.

3. DCAA-Incorrectly Preparing Adjustment Vouchers**a. DCAA Condition**

KBR incorrectly prepares its year-end billing adjustment vouchers. We examined adjustment vouchers on a test basis to determine if the vouchers were properly prepared, mathematically correct, and reconcilable to KBR's accounting records. While performing our evaluation, we noted that the contractor uses year-to-date billed amount to calculate its adjustment voucher amount instead of claimed costs. This calculation is erroneous because of the significant difference between billed and claimed cost. The contractor employed this erroneous billing process on each adjustment vouchers we reviewed.

KBR's system should provide for the segregation of cost by year so that rate adjustments can be easily made and the rates used can be identified.

KBR does not have a sufficient level of control over its process for preparing adjustment year-end voucher, which we believe, can lead to significant over or under billing. Adjusting billing at year-end ensures that the amount of indirect costs reimbursed is as close to the certified amount (claimed cost) as possible.

b. DCAA Recommendation

KBR should develop procedures and controls to ensure that year-end adjustment vouchers are properly prepared. The process should provide for the segregation of cost by year so that rate adjustment can be easily made and the rates used can be identified.

KBR Response to Condition 3:

KBR will formalize the DCAA's recommendation, in conjunction with the FY 2003 incurred cost submission preparation, as part of its billing procedure manual.

1999 is the most current audited and negotiated final indirect cost rate. KBR has submitted adjusting invoices for the actual final un-audited years (FY 2000, FY 2001, & FY 2002) indirect cost rates.

4. DCAA-Lack of Appropriate Reviews and Approvals of Vouchers**a. DCAA Condition**

KBR failed to follow its billing procedures when processing vouchers. We examined 14 interim vouchers prepared between April and August 2003 and found that the contractor had completed neither the project checklist nor the management checklist for two of the 14 interim vouchers. We also found that the contractor had not completed the management checklist on nine of the 14 interim vouchers. The deficiencies noted impact three major contracts, DACA78-99-D-0003, DABT23-01-C-0008 and DAKF11-99-D-0006.

KBR Government Operations Guidelines and General Billing Procedures for U. S. Government Contracts (billing procedures) states "The project business manager (sometimes called project accountant), or designee, must complete and sign the checklist entitled "Project Checklist for Reviewing Invoices before Submittal." The billing procedures also states "The project manager, or designee, must

complete and sign the “Checklist for Management Review of Invoice” before the invoice can be submitted for payment.”

We believe cost-reimbursement contract represent an increased risk to the government when the contractor’s billing system does not protect or detect against billing errors. It is vital that the contractor has controls in place to minimize the risk of over billing the government.

b. DCAA Recommendation

KBR should follow its billing procedures. KBR procedures state that the project business manager should complete both the project checklist and management checklist when processing vouchers.

KBR Response to Condition 4:

KBR has implemented corrective action and is monitoring the completion of the checklists in accordance with the KBR billing procedures

5. DCAA-Failure to Notify ACO of Refunds and Over Payments

a. DCAA Condition

During our audit, we determined that KBR did not notify the Administrative Contracting Officers (ACO) or the paying offices prior to submitting credit public vouchers. A \$382 thousand credit public voucher for contract number N62470-00-D-0005, delivery order 003, invoice number 0208-304-UR651, dated August 27, 2002, was sent to the Navy CONCAP payment office without prior notification to the ACO or paying office. In another instance, a \$17 thousand credit public voucher for contract number DABT-63-98-C-0060, voucher number 03034, was sent to the Army contract paying office without prior notification to the ACO or paying office. In addition, KBR did not include the checks due the government with the credit public vouchers. During 2001, KBR identified and reported to the General Accounting Office three overpayments totaling \$53 thousand relating to contract numbers DAKF11-99-D0066 and FA2550-96-C-0003, but it did not refund the overpayments in a timely manner. Also, in September 2002, KBR identified a duplicate payment of \$107 thousand for Army Corps of Engineers contract number DACA31-97-D-7000, which remains unresolved as of this date.

KBR’s government billing procedures require contacting clients and/or the paying office to resolve issues regarding past-due invoices and any overpayments or underpayments within 30 days of identification of the issue and/or follow up as necessary until final resolution. Also, recently the Federal Acquisition Regulation (FAR) was amended to require the contractor to notify the contracting officer if the contractor becomes aware of an overpayment on a contract invoice (see FAC 2001-02).

KBR is not complying with its policies and procedures for resolving overpayments in a timely manner or within 30 days of identifying overpayment. KBR refunded the Navy contract overpayment for \$382 thousand on June 10, 2003, which was 490 days after the overpayment was made. The \$53 thousand overpayment identified by KBR in 2001 was not resolved until September 2003 or about 845 days after KBR received the overpayment. The duplicate payment of \$107 thousand identified by KBR in September 2002 on the Army Corps of Engineer contract has not been resolved as of this date.

b. DCAA Recommendation

KBR must comply with its policies and procedures for resolving overpayments in a timely manner or within 30 days of identifying an overpayment;

KBR must comply with its policies and procedures and FAR for notifying contracting officers and paying offices to resolve issues regarding past-due invoices and overpayments or underpayments within 30 days of identification of the issue and follow up as necessary until final resolution;

All significant overpayments/duplicate payments or over-billed amounts returned to the paying offices as refunds using credit public vouchers must be accompanied with checks for the amount of the credit voucher; and

KBR needs to ensure significant refunds are made only after notification and instruction from the contracting officer and/or the paying office.

KBR Response to Condition 5:

The duplicate payment of \$107 thousand for contract number DACA31-97-D-700 was resolved with the client's directive in September 22, 2003 and the information was provided to the DCAA October 29, 2003.

KBR has implemented corrective action to comply with its procedure and is currently contacting the client and the paying office by correspondence within the 30 days after identifying an overpayment. After notification the resolution may extend beyond the 30 days, however, KBR will continue to work towards final resolution.

6. DCAA-Lack of Reconciliation of Recorded to Billed Costs and Submission of Final Vouchers

a. DCAA Condition

KBR does not periodically reconcile recorded costs and billed costs on physically complete (but not closed) contracts. Additionally, KBR is not submitting final or completion vouchers for closeout of physically completed contracts on a timely manner. Our review disclosed two contracts, which were physically completed in December 1998, that are in an overpaid status, i.e. billed costs are greater than recorded costs. The LOSC cost reimbursable contract number F08650 -95-C-6038, which was physically completed in December 1998, is overbilled by approximately \$150 thousand. The NASA cost reimbursable contract number NAS9-18787, which was physically completed in December 1998, is over billed by approximately \$28 thousand. Both of these overpayments are unresolved as of this date.

FAR 52.216 -7d requires a contractor to submit completion vouchers for closeout of physically completed contracts within 120 days after settlement of the final indirect cost rates for all years in which the contract incurred costs.

b. DCAA-Recommendations

KBR should establish procedures and internal controls to ensure reconciliations of billed and recorded costs are performed on a periodic basis for all contracts (including physically completed contracts awaiting closeout). Also, KBR should ensure that final vouchers for physically completed contracts are submitted within 120 days after the settlement of the applicable final indirect rates. If

billed costs exceed recorded costs, revised billings and refunds should be submitted within 30 days.

KBR Response to Condition 6:

Please see KBR Response to DCAA Condition 3 above.

7. DCAA-Lack of adequate contract briefings

a. DCAA Condition

KBR does not properly brief its contracts and the associated task orders. Specifically, contracts N62470-00-D-005 and DAAA09-02-D-0007 does not have a contract brief on each of the associated task orders. The contractor prepares a contract summary which summarized the contract and the task orders. The contract summary included information such as performance period, brief description, and the cost of the contract or task order as modified. The contract summary does not identify special requirements or limitations nor does it identify the contract clauses relative to the specific task orders.

KBR's Contract Policy & Process, CA-S-03, dated August 29, 2002 states the contractor "shall develop a contract post award summary and the DCAA contract brief" as soon as possible but no later than three business days after contract award. The policy continues on to state, KBR "shall update the DCAA Contract Brief or KBRSI Contract Billing Summary as needed (i.e., upon receipt of the contract modification but, no less than on an annual basis)."

b. DCAA Recommendation

We recommend KBR brief each contract and task order as prescribed by its policies and procedures. We also recommend that KBR include any special requirements or special limitations in each of the contract briefs.

KBR Response to Condition 7:

KBR will to the maximum extent practicable ensure that contract briefs include billing details, contract types and other pertinent data important for the billing process.

8. DCAA-Billing of Unallowable Costs

a. DCAA Condition

BRS billed unallowable costs on Contract No. F04701 -90-C-0080. BRS's final invoice included approximately \$45,000 in costs including overhead and G&A that had been determined to be unallowable by DCAA in Audit Report No. 3521-95 D10160003, dated September 30, 1997, and agreed-to by the contractor. The contractor reduced interim vouchers for the questioned costs, but BRS did not reclassify the questioned costs to an unallowable account in the ledger. BRS prepared the final voucher from its accounting records which did not reflect the unallowable costs, resulting in billing the unallowable costs in its final voucher. We believe the lack of written general billing procedures prescribing actions to take regarding costs determined to be unallowable under these or similar circumstances has contributed to this condition.

b. DCAA Status of Corrective Action Taken on Prior Recommendations

The contractor developed and implemented KBR Government Operations Guidelines and General Billing Procedures for U. S. Government Contracts (billing procedures) dated November 1, 2002. We believe the billing procedures addressed the unallowable/unallocable costs criteria necessary for the billing system.

KBR Response to Condition 8:

KBR concurs with the DCAA's position.

9. DCAA-Inadequate Controls over the Dining Facility Subcontract Cost Billing Process

a. DCAA Condition: DCAA Condition

1.1:

KBR's internal controls over payments to subcontractors are inadequate. The existing process does not provide assurance that payments made to Dining Facility (DFAC) subcontractors and billed to the Government are adequately supported and computed in accordance with prime contract and subcontract terms and conditions. The LOGCAP III contract requires KBR to provide DFAC services in support of Government operations in Iraq and Kuwait. Since the inception of LOGCAP III in Kuwait and Iraq, KBR has awarded DFAC subcontracts to seven different subcontractors. The early subcontracts were awarded as stand alone subcontracts. Later DFACs were subcontracted under work releases to Master Agreements, which are similar to Basic Ordering Agreements.

KBR Response To 9.1.1:

KBR's position is that the issues cited by DCAA in support of this Statement of Condition (9.1.1) have been misquoted as well as misinterpreted. The end result is that a difference of opinion between DCAA and KBR regarding certain DFAC subcontract terms is now mischaracterized herein as a billing system control deficiency.

DCAA is aware that KBR established a Tiger Team that is actively researching and analyzing the facts and circumstances surrounding each of its DFAC subcontracts. This effort includes a thorough review and analysis of past subcontract payment practices as well as developing standardized subcontract practices for future DFAC subcontracts.

Thus, KBR believes any conclusion at this time regarding KBR's billing procedures related to the payment of DFAC subcontracts is not only unsubstantiated but also premature.

DCAA Condition 1.2:

KBR is paying DFAC subcontractor invoices that are not reasonable in amount and are not computed in accordance with subcontract terms and conditions.

*The subcontract required the subcontractor to create a billing format to include "meals served for each billing item." The subcontract indicates that **meals served** will be the basis of the billed amounts as follows:*

*“SUBCONTRACTOR will create a Subcontract billing format acceptable to CONTRACTOR, to be used for all payments. This form will include, but not be limited to the full name and address of the Subcontractor work performed, and **meals served** for each billing item; the previous billed amount; the ‘to date’ billed amount; the billing period, and the SUBCONTRACT number.”*

The actual billing methodology did not consider actual meals served in determining the billing amount, despite the expressed terms of the subcontract. Instead, as far as we have been able to determine, KBR relied on the undocumented “Mayor Cell Count,” which was not authorized in the contract. We don’t believe the “Mayor Cell Count” was a reasonably close approximation of meals served. However, KBR stated that payments to its DFAC subcontractor were based on “Mayor Cell Counts” provided by one or more Non Commissioned Officers or in some cases, a warrant officer. The Mayor Cell Count was provided for planning purposes only and was never intended to be used for billing. The numbers that were provided to KBR for planning purposes can not be independently verified. KBR asserted that the number was provided verbally to them and could not be written down because it was considered classified. We found, however, that KBR wrote down and used this “classified” number in their billings to the Government. The use of the undocumented “Mayor Cell Count” as a basis for payment has resulted in billings to the Government for as much as three times the meals actually served.

KBR Response To 9.1.2:

Please see KBR’s response to 9.1.1 above.

DCAA Condition 1.3:

The prime contract required KBR to develop, coordinate and publish a standard operating procedure for food service personnel to include instruction sheets for headcounters. Until December 18, 2003, KBR never issued a procedure addressing headcount procedures. Having an adequate headcount procedure in place would have provided an accurate count of meals served for billing purposes.

KBR Response to condition 9.1.3:

Please see KBR’s response to 9.1.1 above.

DCAA Condition 1.4:

KBR has not maintained adequate controls over the subcontract payment process for DFACs subcontracted under Master Agreements. KBR is not adequately monitoring subcontractor invoices for compliance with prime contract and master agreement terms and conditions. The subcontract payment terms state that the subcontractor will create a billing format that will include “the number of persons that actually ate breakfast, lunch, dinner, and midnight meals formulated from sign in sheets for each meal.” KBR is not using sign in sheets across all master agreement DFACs. In addition, KBR has been billing at projected headcounts rather than actual meals served on at least one of the subcontracts. (This practice has recently been discontinued pending resolution of outstanding billing issues.) Despite repeated requests over two months, KBR has not been able to provide an adequate explanation or adequate documentation for the payments to any DFAC subcontractors. The limited documentation that has been provided shows, for example, that KBR has added “overage” factors of 10 to 35 percent to each bill for one of the subcontractors. We still do not have an adequate explanation of the “overage” factor. We saw a reference to a 10 percent factor as a “wastage” amount in the subcontract correspondence file, but no reference to a 35 percent factor.

A contractor should be able to provide supporting data for its billed costs when a routine audit inquiry is made. A system should be in place to provide such supporting documentation in a reasonable time frame. Our first request for supporting data was made as early as November 9 and followed up with several additional requests. On February 1, 2004, we did receive some supporting data, but it is far less than we requested. The fact that KBR has been unable to demonstrate the process for monitoring and paying subcontractor DFAC invoices shows that a significant internal control deficiency exists.

KBR Response to condition 9.1.4:

Please see KBR's response to 9.1.1 above.

DCAA Condition 1.5:

We identified an instance where the KBR DFAC subcontract negotiator was also one of three KBR representatives responsible for approving DFAC subcontractor invoices for the same subcontract he negotiated. This procedure does not represent adequate segregation of duties for internal control purposes. We believe that this could have been a contributing factor to the continued billing issues we identified on the DFAC subcontract for site 5a at Arifjan.

A different subcontract administrator from the one who negotiated the original subcontract should have been required to approve the billings. If this were the case, the billing issues could have been identified at an early stage and possibly corrected.

KBR Response to Condition 9.1.5:

Please see KBR's response to 9.1.1 above.

b. DCAA Recommendation:

DCAA Recommendation 1:

KBR should implement a standardized DFAC subcontract payment process. The procedures should require that subcontracts include clear and reasonable payment terms. The negotiated subcontracts should have a detailed level management review to identify any shortcomings. Appropriate personnel should review the billings to verify that the services have actually been provided and that the amounts invoiced are in accordance with payment terms. Authorization for payment should come from a KBR procurement official who was not involved in negotiating the subcontract.

KBR Response To Recommendation 9.1

Please see KBR's response to condition 9.1.1 above.

DCAA Recommendation 2:

KBR should perform an internal analysis of the billing issues we identified and determine the cost impact. Amounts which can not be supported for payment in compliance with prime and subcontract terms should be voluntarily withdrawn from billings until such support can be provided.

KBR Response To Recommendation 9.2

Please see KBR's response to condition 9.1.1 above.

DCAA Recommendation 3:

KBR should use actual headcount/meals served as a basis for their subcontractor's billings in accordance with the terms of the contract. Subcontracts with DFAC vendors should be renegotiated to reflect reasonable terms based on actual services provided.

KBR Response To Recommendation 9.2

Please see KBR's response to condition 9.1.1 above.

END OF DOCUMENT

NOTE: This KBR Response to DCAA Audit Assignment No. 3311 -2002K11010001 contains proprietary and confidential information which is authorized to be withheld from the public . Disclosure would cause a foreseeable harm to an interest protected by one or more Exemptions of the Freedom of Information Act, 5 USC Section 552. Furthermore, it is requested that any Government entity receiving this information act in accordance with DoD 5400.7-R, and consider this information as being for official use only (FOUO), and mark, handle and secure this information so as to prevent unauthorized access.

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